United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

Signed

75-4193

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

AHMET ERTEGUN and IOANA ERTEGUN,
Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellee

GERALD WEXLER and SHIRLEY WEXLER,
Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellee

NESHUI ERTEGUN and BELKIS ERTEGUN,
Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellee

ON APPEAL FROM THE DECISIONS OF THE
UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

SCOTT P. CRAMPTON,
Assistant Attorney General,

GILBERT E. ANDREWS,
JONATHAN S. COHEN,
ARTHUR L. BAILEY,
Attorneys,
Tax Division,
Department of Justice,
Washington, D.C. 20530.

2

TABLE OF CONTENTS

CITATIONS

Cases:

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 75-4193

AHMET ERTEGUN and IOANA ERTEGUN,
Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellee

GERALD WEXLER and SHIRLEY WEXLER,
Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellee

NESHUI ERTEGUN and BELKIS ERTEGUN,
Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellee

ON APPEAL FROM THE DECISIONS OF THE
UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

STATEMENT OF THE ISSUE PRESENTED

Whether the Tax Court correctly ruled that taxpayer could not exclude from its gross income in the current year an amount representing a portion of its estimated future and contingent liability to distributors for returns of unsold records.

STATEMENT OF THE CASE

This appeal involves the Tax Court's determination of income tax deficiencies in the amount of $55,073.92 (for Gerald and Shirley Wexler), $6 ,305.63 (for Ahmet and Ioana Ertegun) and $ 6,681.14 (for Nesuhi and Belkis Ertegun) all for the tax year 1967. (R. 131a, 133a, and 135a.)[1/] A trial was held before the Tax Court (Judge Quealy) on June 13, 1974. (R. 15a.) The court's "Memorandum Findings of Fact and Opinion" was filed February 13, 1975, and is reported at P-H Memo T.C., par. 75,027 (1975). The court's decisions reflecting the above deficiencies were entered May 23, 1975. (R. 2a, 4a, 6a.) Timely notices of appeal were filed on behalf of the above-named taxpayers on August 15, 1975. (R. 2a, 4a, 6a.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

The material facts, as stipulated (R. 7a-14a), as found by the Tax Court (R. 114a-122a), and as otherwise appearing of record may be briefly stated as follows:

During the tax year involved, Atlantic Records Sales Company, Inc. (hereinafter referred to as Atlantic) was engaged in the business of selling phonograph records, including

---

1/ "R." references are to the separately bound record appendix.

45-rpm singles and 33-rpm albums at wholesale. The individual taxpayers named in this proceding were the stockholders in Atlantic during the relevant period. Since Atlantic was treated as a small business corporation under Section 1371 of the Code, its income was taxed directly to these individuals. (R. 116a.) To simplify matters, the shareholders collectively will be referred to as "taxpayers." Atlantic regularly did business with approximately 58 distributors--41 of these were considered to be its "regular distributors," while the remaining 17 distributors consisted of post exchanges, mail order houses, and exporters. (R. 117a.)

Atlantic's regular distributors were granted what has been referred to on the invoices (R. 103a) as a "10% quarterly return privilege." Under this arrangement, Atlantic permitted its distributors to return, at the end of each calendar quarter, unsold records for credit. The 10-percent figure represented the maximum amount of records (10 percent of gross sales in a prior quarter) which a distributor normally would be allowed to return. However, on a case by case basis, Atlantic would allow a distributor who had "surplus", or "overstocked" records over and above the 10-percent ceiling to return more than the amount for credit. (R. 79a, 91a, 119a.) According to Atlantic's finance officer, Sheldon Vogel, who testified at trial, extra returns over

the normal 10-percent limit occurred "very often." (R. 79a.)[2/]

The records which Atlantic permitted to be returned were records bearing its own labels which had not been sold at retail. Atlantic's royalty obligations to artists was based on the retail list price of records sold, net returns (R. 44a), and since the records returned to it had not been sold at retail, Atlantic was able to reduce its royalty obligations to artists on account of such returns (R. 44a-45a). As the record shows (R. 45a), and as the Tax Court found (R. 119a), the records returned for credit under the 10-percent return authorization generally were surplus or overstocked records in a distributor's inventory (R. 79a, 91a). If the distributor did not have enough excess singles in his own inventory, he was allowed to purchase additional surplus records from its customers (subdistributors or retailers), jobbers, or other dealers in distress merchandise at a reduced price (5 to 15 cents each), and return them for full credit ($.38 per record) up to the 10-percent maximum allowed. (R. 45a-46a, 79a, 90-91a, 119a.)

2/ Taxpayer's statement of the case (Br. 3-6) contains the argumentative assertion (Br. 4), which goes to the heart of the issue presented here, that it gave its distributors a 10-percent price discount on sales of singles, and that this "discount arrangement was known as a 10 percent return privilege." Whatever legal effect which should be given this arrangement, i.e., whether it should be treated as a 10-percent price discount, as contended by taxpayers, or as a typical sale-or-return arrangement with a 10-percent ceiling on returns, as contended by the Government, is a matter discussed in the argument portion of this brief.

Atlantic's record sales and returns were handled as follows: When a sale occurred, Atlantic would issue an invoice for the full wholesale price of the goods ($.38 per single) and increase accounts receivable in a like amount. (R. 50a, 120a.) The invoice (R. 103a) provided, and taxpayers' witness testified (R. 41a-42a), that the entire invoice price was due on the 10th day of the month following the month in which the sale occurred. In addition, the invoice price was the base to which Atlantic applied a two-percent discount for prompt payment. (R. 41-42a, 84a, 120a.) The invoice also provided that no return of records was allowed without Atlantic's authorization. (R. 95a, 103a.) At the close of each calendar quarter, Atlantic would compute the 10-percent maximum returns allowed for each distributor and issue a return authorization. This occurred between two and three weeks after the close of the quarter. (R. 68a, 93a-94a.) The distributor would package and return to Atlantic's factory the records it wanted to return for credit. This took approximately 7 to 10 days. (R. 93a-94a.) The records were returned, and Atlantic would issue a credit memorandum about two weeks later. (R. 94a-95a, 101a.) In addition to allowing a credit to the distributors for returned records, Atlantic would make a corresponding reduction in its royalty obligations to artists which were based on the retail list price for record sales, net returns. (R. 69a, 119a.) If the distributor did not return records, or failed to return

records within a reasonable time after the issuance of the return authorization, taxpayers' witness testified that no credit would be given. (R. 68a.) (This apparently did not occur during the year in issue.)

Atlantic's 1967 tax year ended May 31, 1967, one month before the end of the second calendar quarter, which ended June 30, 1967. Anticipating the returns that it expected to receive from its distributors for credit at the end of the second calendar quarter, Atlantic reduced gross sales in the current year by 10 percent of the sales of records occurring during the first two months (April and May) of the second quarter. Atlantic computed this accrual based on the fact that the 10-percent return privilege was computed with reference to gross sales during this period, and the fact that distributors always returned records up to the 10 percent maximum. Upon an examination of Atlantic's return, the Commissioner disallowed the claimed offset or deduction in the amount of 10 percent of the April and May sales. (R. 121a-122a.) In the Tax Court, taxpayers argued that the 10-percent return privilege in effect constituted a price discount (R. 126a), and that Atlantic could properly reduce gross income in the current year by 10 percent of gross sales during the April through May period. In the alternative, taxpayers argued (R. 129a) that Atlantic was entitled to accrue a deduction in the current year for the estimated amount of a portion of its potential liabilities for returns of records which it anticipated at the close of the second calendar quarter (one

month after the close of the tax year). Upholding the Commissioner's disallowance, the Tax Court ruled that there was no 10-percent price discount, and that this was a typical sale-or-return arrangement, pursuant to which Atlantic was required to report the full sales price in the year of sale. (R. 130a.) Further, Atlantic could not accrue an immediate deduction for its estimated future liabilities for record returns, for such an estimated expense is a contingent item for which an accrual method taxpayer cannot claim a current deduction. (R. 129a.)[3/] Taxpayers appeal from this adverse decision.

3/ Under a typical sale-or-return arrangement the taxpayer would reduce gross sales or claim a deduction from income in the year in which, in fact, the unsold merchandise is returned and the taxpayer's liabilities to the distributor for a credit becomes fixed. With respect to the credits claimed in this case, this would occur sometime after the close of the second calendar quarter (June 30, 1967), after the close of the tax year in issue.

SUMMARY OF ARGUMENT

This case involves the proper treatment for tax purposes of an arrangement pursuant to which Atlantic permits its distributors to return unsold merchandise (records) for credit and the end of each calendar quarter. Under this arrangement, distributors are regularly permitted to return unsold records in an amount up to 10 percent of the gross purchases from Atlantic during the preceding calendar quarter. This is referred to as the "10 percent return privilege." In addition, Atlantic permitted distributors to return more than the normal 10-percent limit, on a case by case basis. The Tax Court correctly viewed this as a typical sale-or-return arrangement, the proper tax treatment for which is not in dispute. In a typical sale-or-return transaction, the taxpayer reports the total sales as income when the sales occur, and then later, when the return of unsold goods takes place, the taxpayer is entitled to reduce its sales income by the amount of any resulting credits or allowances. In a typical sale-or-return transaction, the taxpayer cannot estimate future returns and claim a current offset or deduction for such anticipated returns.

Taxpayers contend this is not a typical sale-or-return arrangement, and that, in effect, Atlantic provided its distributions with a 10-percent <u>price</u> discount, and that it has to include as income in the year of sale only 90 percent of the invoice price of the goods it sells. The contention is

wholly without merit. It is clear that the invoice price was the actual wholesale selling price for these records (as Atlantic's finance officer admitted at trial), and that unless and until the distributors returned unsold records at the close of the calendar quarter (which ended one month after the close of the 1967 tax year in issue), the distributors were liable to Atlantic for the full amount of such invoices--which were reflected, without discount, in Atlantic's accounts receivable. Indeed, the invoice price was treated by Atlantic and its distributors as the selling price when, for example, the parties computed the two-percent discount for prompt payment. (The invoice provided, and Atlantic's finance officer admitted, that the full invoice price was due on the 10th day of the month following the month of sale)

A simple analysis of the facts demonstrates that the "price discount" (upon which taxpayers' theory is based) is illusory. The only way taxpayers have created this imaginary discount is by comparing the invoice price for a given number of records initially sold with the amounts Atlantic ultimately receives after allowances for unsold records returned. Since distributors regularly return the full amount of unsold records allowed under the regular 10 percent return privilege, Atlantic's gross sales eventually are diminished by 10 percent. But the 10-percent reduction in gross sales does not occur because of a price discount for the records sold and not returned by the distributors; rather it

follows because a full credit is allowed for unsold records, up to a maximum of 10 percent of sales in a prior quarter. Atlantic's price discount is illusory; and lends no support to taxpayers' "substance-over form" attack on the lower court's decision.

In the alternative, taxpayers contend that Atlantic should be permitted to accrue its estimated liability to distributors for future, anticipated returns of unsold records and claim a deduction in the current year for this future potential liability. This it cannot do. Atlantic is an accrual basis taxpayer, and it is well established that an accrual basis taxpayer cannot accrue an item of expense until all events occur which fix the taxpayer's liability. Under this so-called "all-events test," a taxpayer cannot claim a current deduction for an item of taxpayer's liability for which is contingent on the occurrence of some future event. The liability at issue here is clearly contingent. A distributor will not receive a credit for returned merchandise until and unless the unsold records are in fact returned at the close of the calendar quarter, which occurs after the close of the tax year in issue. If the records are not returned, or if the records are not returned within a reasonable time after Atlantic issues its authorization for such returns, the credit will not be allowed, as taxpayers' witness conceded at trial. Accordingly, the expense cannot be accrued and a deduction claimed currently for this item, as the Tax Court below properly ruled.

The cases upon which taxpayers rely for the accrual of this expense, principally Central Cuba Sugar Co. v. Commissioner, 198 F. 2d 214 (C.A. 2, 1952), cert. denied, 344 U.S. 874 (1952), are not in point . In Central Cuba Sugar Co. substantially all events which fixed the taxpayer's liability for the commissions expenses in issue had occurred during the tax year. Here, on the other hand, none of the important contingencies (i.e., prompt return of unsold records) occur until the subsequent tax year. Moreover, this Court in Central Cuba Sugar Co. advanced the view that in order to match income and related items of deductions, taxpayers should be permitted to establish "reserves" for future expenses and claim current deductions for additions to such "reserves." Shortly after Central Cuba Sugar Co. was decided, a provision permitting such reserves was added to the tax law but was repealed one year later. Subsequent decisions of the Supreme Court and other courts interpreting this repeal make it clear that under no circumstances can taxpayers establish "reserves" and claim current deductions for future contingent expenses (except where expressly authorized by Congress) on an income and deduction matching theory. In view of these developments, taxpayers have placed unwarranted reliance on the Central Cuba Sugar Co. decision.

The decision of the Tax Court is correct and should be affirmed.

ARGUMENT

THE TAX COURT CORRECTLY RULED THAT ATLANTIC COULD NOT REDUCE GROSS INCOME FROM SALES OF RECORDS IN THE CURRENT YEAR, EITHER BY EXCLUSION OR DEDUCTION OF THE AMOUNT OF ITS POTENTIAL LIABILITY TO DISTRIBUTORS FOR RETURNS OF MERCHANDISE IN THE SUBSEQUENT YEAR

A. Atlantic must include as gross income under Section 61 of the Internal Revenue Code of 1954 the entire invoice price of records sold its distributors

Section 61 of the Internal Revenue Code of 1954, Appendix, infra, provides that gross income includes "all income from whatever source derived, including * * * gross income derived from business * * *." The Treasury Regulations on Income Tax (1954 Code), Section 1.61-3 (26 C.F.R.), provide that in a manufacturing or merchandising business, "gross income" means "total sales" less costs of goods sold, plus any income from investments or other outside sources.

Generally, of course, "total sales" would be the amount of the invoice price of goods sold and, for an accrual-basis taxpayer, such sum would be the amount by which the taxpayer's account receivable increase as a result of such sales. As the court in Spring City Co. v. Commissioner, 292 U.S. 182 (1934), stated (p. 185):

> On an accrual basis, the "total sales", to which the regulation refers, are manifestly the accounts receivable arising from the sales and these accounts receivable, less the cost of the goods sold, figure in the statement of gross income.

There is no reason to believe that the taxpayers here would dispute this starting point in a determination of gross

income for purpose of Section 61 of the Internal Revenue Code of 1954. Taxpayers contend, in effect, that the amount of Atlantic's "total sales" for purpose of Section 61 of the Code is not established by the total invoice price of the records it sold, or by the amount of the accounts receivable generated by such sales of records, but that the true selling price was actually 90 percent of the invoice price, and that this amount should be sued in computing gross income.[4/] There is, as we will show, no support for taxpayers' position. It is contrary to the testimony of Atlantic's own finance officer, and inconsistent with the testimony of one of Atlantic's distributors (the only two witnesses in the court below). Moreover, there is no documentary evidence of record which would indicate that the real selling price (on the invoice and reflected in Atlantic's accounts receivable) was other than the stated price. On this record, the Tax Court correctly treated the invoice price of records sold as the true selling price for purpose of computing Atlantic's gross income.

4/ Taxpayers apparently would have this Court believe that their first contention (Br. 7-15) is governed by the provisions of Section 451 of the Internal Revenue Code of 1954 (26 U.S.C.), and that the issue raised concerns the proper time for reporting gross income, as opposed to the question whether a particular item constitutes gross income at all. Although taxpayers fail to even mention Section 61, it is clear from their position (i.e., that the real selling price was not the invoice price, but rather 90 percent of such price), and from the cases upon which they rely. (Br. 7.) See, e.g., Atzingen-Whitehouse Dairy, Inc. v. Commissioner, 36 T.C. 173 (1961), and Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707 (1956), however, that the initial question concerns an application of the definition of gross income for purposes of Section 61 of the Code and, more specifically, the extent to which Atlantic realizes gross income from the sale of records.

The fact that the invoice price reflected the real selling price was recognized by Atlantic's chief financial officer, Sheldon Vogel, who testified at the trial. In this regard Vogel testified (R. 50a) that --

> Again, at the time of the sale, we would bill out or invoice out the purchase at the full wholesale price, which would be an increase to sales for the full amount of the invoice, and a full increase of accounts receivable for that amount. (Emphasis added.)

Aside from detailing the bookkeeping practice for the sales, this testimony acknowledges that the invoice price in fact was the "full wholesale price."[5/] One of Atlantic's employees (Leonard Rakliff) also testified at trial. Rakliff's testimony clearly shows his understanding that the credits allowed for returned merchandise (unsold records) was an allowance for returns--not a price discount for the records it purchased from Atlantic which were not returned. Moreover, Rakliff at least implicitly recognized (R. 94a) that the distributor was obligated for the full amount of the invoice, and the full amount stated in its account receivable until such time as the credit for returned records was allowed. (Under taxpayers' analysis, a distributor would be liable to Atlantic for only 90 percent of distributors' accounts receivable).

5/ The above testimoney relates to Atlantic's sale of "singles" -- 45-R.P.M. records. The witness made similar statements concerning the selling price of 33 1/3-R.P.M. albums. (R. 36a.)

Further, the only documentary evidence of Atlantic's transactions with its distributors concerning its sales were the invoices themselves. The invoices, of course, stated the full price of the records, and indicated that payment of the full price was due in 10 days. (See Ex. 9; R. 103a.) Moreover, the invoice price was treated as the selling price by the parties when, for example, they determined the two-percent discount for prompt payment. (R. 41a-42a, 84a, 105a.) Surely there would be no point in using the invoice price in determining the two percent cash discount unless such price reflected the party's true agreement. Moreover, as taxpayers' witness testified (R. 42a), the <u>full invoice price</u> for single records (and not the 90 percent figure which would be the case under their discount theory) was due on the 10th day of the month following the month of sale. This evidence plainly shows that the invoice price was the real selling price, and that the amounts so reflected in the accounts receivable represented the amounts owed Atlantic by its distributors.

Taxpayers rely on Atzingen-Whitehouse Dairy, Inc. v. Commissioner, supra, and Pittsburgh Milk Co. v. Commissioner, supra, for the proposition that Atlantic does not have to report the full invoice price of the records Atlantic sold. These cases are distinguishable, and if anything show the obvious error in taxpayers' position. Both cases involved sellers who wanted to avoid the controlled price for milk. The invoice price was at the controlled price, but the parties in fact agreed to a lesser price which was paid, or, if the invoice price were paid, the taxpayer-seller would rebate the excess. In these cases there was a definite purpose to circumvent a regulated price, and the parties established that the actual agreement was for the reduced amount. (Further, the reduced price was not subject to any contingencies.) In accordance with the real agreement of the parties, the Tax Court ruled that the taxpayer-sellers were required to report only the reduced amount as their sales proceeds; there was no right to receive more than the reduced amount. Taxpayers in the case at bar have not established that the invoice price did not constitute the actual selling price. Moreover, all the evidence presented below affirmatively establishes that Atlantic's distributors in fact agreed to pay the full invoice price, and that Atlantic had a policy of permitting distributors to return unsold records up to a maximum of 10 percent of gross purchases in a preceding quarter.

It is clear in the present case that there is in fact no "price discount" (even under taxpayers' treatment for these items) but that, instead, taxpayers have created a discount out of whole cloth in an effort to come within the scope of the above-cited cases upon which they rely. The illusory nature of their so-called "discount" is illustrated by the following hypothetical. Assume that a distributor buys 1,000 records for an invoice price (at \$.38 each) of \$380, and assume further that the distributor sells 900 records and returns 100 records (the maximum allowed) for a full credit (at \$.38 each) of \$38. It is true that the \$342 amount Atlantic ultimately receives (\$380 - \$38 = \$342) is 90 percent of the initial \$380 invoice amount. But taxpayers ignore the point that Atlantic has not sold 1,000 records for \$342; rather it has sold 900 records for \$342 -- and there is simply no discount at all present. In fact, the distributor pays the full invoice price (\$.38 per record) for the 900 records it retains.

The way taxpayers create this phantom discount is by ignoring the fact that 100 records are returned to Atlantic for credit. The existence of these elusive 100 records is certainly of no small significance to the distributor, who has agreed to pay for them, and who receives a credit for their return.

Nor are these returned records unimportant to Atlantic which reduces its royalty obligations to artists on account of such returns.[6/] We agree with taxpayers (Br. 7, 18) that substance should prevail over form in tax matters (although we note that here taxpayers seek to disregard the form Atlantic established for these dealings), but we submit that the "substance" taxpayers allege in this case, viz., the price discount, is nothing but a mirage. [7/]

On the evidence of record, the Tax Court reached the only possible result in concluding that, in substance as well as form, there was no 10-percent price discount, and that the records returned to Atlantic for credit under the 10-percent return privilege were part of a typical sale-or-return arrangement. See e.g., J.J. Little & Ives Co. v. Commissioner, 25 T.C.M. 372 (1966) and Scott Krauss News Agency, Inc. v. Commissioner, 23 T.C.M. 1007 (1964), involving sale-or-return transactions covering books and magazines. (Taxpayers

6/ The nonexistence of a price discount may also be shown by an extension of the previously stated hypothetical. Assume the distributor who purchases 1,000 records (at \$ .38 each for \$380) returns 100 for a \$38 credit (at \$ .38 per record), and pays the balance of \$342 (\$380 - \$38). If the invoice price for the records retained by the distributor actually was subject to a 10-percent discount, the distributor would pay only 90 percent of the invoice price for 900 records (.90 x (\$ .38 x 900) = \$307.80). Even taxpayers would not contend that Atlantic should only report as income \$307.80, when it in fact receives \$342.

7/ See Commissioner v. Hansen, 360 U.S. 446, 461-462 (1959) where a similar attempt by a taxpayer to recreate the facts in a substance-over-form type argument was rejected.

apparently concede (Br. 12-14) that in a sale-or-return situation the seller includes the entire sale as income in the year of sale, and that a reduction in sales occurs when the unsold goods are returned in the proceeding period.) The facts presented here show that Atlantic regularly permitted distributors to return unsold records in an amount up to 10 percent of gross sales in the preceding quarter, and that on a case-by-case basis Atlantic permitted distributors to return even greater amounts of overstocked or excess records. Clearly, this constitutes a standard sale-or- return arrangement. Having argued the "10-percent-price-discount theory", however, taxpayers have painted themselves into a corner, and, in an attempt to extricate themselves from this position, advance the untenable contention that somehow the record returns which did not exceed the 10-percent maximum did not constitute typical returns of unsold records, but that the records Atlantic permitted to be returned over and above the 10-percent figure in fact constituted returns of unsold goods. Taxpayers apparently believe that by placing a ceiling (10 percent of gross sales in a prior quarter) on the amount of records Atlantic permits to be returned on a regular basis, it can transmogrify a simple sale or return arrangement into something which simply is not present--a price discount.

In any event, there is no support in the record for such a distinction. Both of taxpayers' witnesses at trial--Vogel,[8] Atlantic's finance officer, and Rakliff,[9] the distributor's employee, recognized that the record returns under the 10-percent return privilege, and negotiated returns over and above that limit were the means through which "surplus" or "overstocked" records were returned. This evidence fully supports the Tax Court's finding that both forms of record returns were part of the same sale-or-return arrangement. (R. 119a).

8/ The transcript (R. 79a) contains the following explanation (by Vogel) as to why a distributor was allowed a credit for returned records over and above the regular 10-percent limit:

> Q. How come the distributor was granted $33,000 in credit for that period?
>
> A. The distributor must have had surplus singles on hand over and above what he returned on the return privilege, and no doubt requested additional returns, which we would have granted, based on the numbers here.
>
> Q. Was this often the case?
>
> A. Very often.

9/ On the same subject Rakliff testified (R. 91a) as follows:

> Q. Did you ever return singles on excess of that automatic amount?
>
> A. Yes, we did. On occasion, we were overstocked on other records that we got an extra ten--we got an extra return* * *.

In an attempt to justify their case, taxpayers observe (Br. 4, 6, 14) that Atlantic's distributors always returned the entire permissible quantity of records--in an amount equal to 10 percent of record purchases in the prior quarter. Contrary to taxpayers' contention, this does not prove that the credits represented "price discounts." All this fact shows is that the 10 percent of gross sales limit on record returns was a conservative limitation, and that at any given time there were sufficient unsold records available to meet the maximum return figure. The fact that Atlantic's distributors were permitted to return records they bought at a discount from "jobbers" or "people that dealt in distress merchandise" (R. 90a) shows only that through such an arrangement Atlantic provided a system through which subdistributors and retailers could indirectly return unsold records to Atlantic. The important point is that in all cases the records returned had not been sold at retail, an essential factor which permitted Atlantic to reduce its royalty obligation to artists. (See. R. 44a, 119a, and taxpayer's br. 4.) 10/

10/ Taxpayers also rely (Br. 11) on other cases involving trade discounts which were properly treated as adjustments in the selling price which should be taken into account in determining gross income. (See e.g., Becken v. Commissioner, 5 T.C. 498 (1945) involving trade discounts given by a wholesale jewelry business, and Tri State Beverage Distributors, Inc. v. Commissioner, 27 T.C. 1026 (1957), involving trade discounts given by a wholesale liquor business. These cases, like the Pittsburgh Milk Co. and Atzinger cases have no application here.) Taxpayers also rely (Br. 11) on American Cigar Co. v. Commissioner, 21 B.T.A. 464 (1930) aff'd, 66 F. 2d 425 (C.A. 2, 1933), but that case involved (21 B.T.A., p. 499) anticipated cash discounts for prompt payment which are not at issue here.

B. THE TAX COURT WAS CORRECT IN RULING THAT ATLANTIC COULD NOT DEDUCT IN THE CURRENT YEAR THE ESTIMATED AMOUNT OF ITS FUTURE LIABILITY TO DISTRIBUTORS FOR RETURNS OF UNSOLD RECORDS

Section 461(a) of the Internal Revenue Code of 1954, Appendix, infra, provides that deductions "shall be taken for the taxable year * * * under the method of accounting used in computing taxable income." A variety of permissible accounting rules and methods are recognized in the Internal Revenue Code provisions, including the cash receipts and disbursements method and the accrual method. See Section 446(a) and (c) of the Internal Revenue Code of 1954, Appendix, infra. Atlantic in the case at bar is an accrual basis taxpayer. (R. 9a.) This case involves the proper treatment, under an accrual method of accounting, for the estimated, furture liability of Atlantic to its distributors for returns of unsold records.[11/]

11/ Atlantic permits distributors to return unsold records at the close of each calendar quarter and, as we have shown, generally limits the amount of records which may be returned to 10 percent of sales to each distributor during the past quarter (except on a case by case basis when it permits greater returns). Atlantic is a fiscal year taxpayer with a tax year ending May 31, which causes its tax year to fall two-thirds into the second calendar quarter (April 1-June 30). The deductions in issue and claimed by Atlantic in the tax year ending May 31, 1967 represent a portion of the credits and allowances it expects to issue in the following tax year some time after the close of the second calendar quarter on June 30, 1967.

The long-standing test for the accrual of items of deduction is set forth in Section 1.461-1(a)(2) of the Treasury Regulations on Income Tax (1954 Code), Appendix, infra, which provides in part:

> Under an accrual method of accounting, an expense is deductible in the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy.

And, further provides that:

> * * * no accrual shall be made in any case in which all of the events have not occurred which fix the liability * * *.

Thus, it is clear that two requirements must be met before an expen item can be accrued. First, "all events" which fix liability of the taxpayer for the expense must have occurred. Second, the taxpayer must be able to determine the amount of the liability (and hence the deduction) with reasonable accuracy. This strict, two-fold test set forth in the Treasury Regulations for the accrual of an expense deduction finds its basis in the Supreme Court decision in United States v. Anderson, 269 U.S. 422, 441 (1926), and has been uniformly applied by the Supreme Court in later decisions (See Brown v. Helvering, 291 U.S. 193 (1934), and United States v. Consolidated Edison Co., 366 U.S. 380 (1961), and by this and other circuit courts. See e.g., Commissioner v. H.B. Ives Co., 297 F. 2d 229 (C.A. 2, 1961); United States Industrial Alcohol Co. v. Helvering, 137 F. 2d 511 (C.A. 2, 1943); Peoples Bank and Trust Co. v. Commissioner, 415 F. 2d 1341 (C.A. 7, 1969),

and Field Enterprises, Inc. v. United States, 348 F. 2d 485 (Ct. Cl., 1965) cert. denied, 382 U.S. 1009 (1966). As these cases recognize, an accrual basis taxpayer cannot claim a deduction in the current year for a future, contingent expense.[12/]

When the "all-events test" is applied to the facts presented here it is clear, as the Tax Court below ruled (R. 129a), that Atlantic cannot accrue an expense and claim a current deduction for its estimated liability for the returns and allowances in question. Atlantic's liability to distributors for credits on account of returned merchandise is not fixed until the records are in fact returned. The deductions in question relate the estimated amount of records to be returned at the close of the second calendar quarter (June 30, 1967), and since

12/ In the Ives and United States Industrial Alcohol Co. cases this Court dealt with the proper time for the accrual of expenses for insurance coverage where the taxpayer agreed to purchase a policy in the current year, but did not in fact acquire the policy until the following year (Ives), and for the accrual of income from the sale of stock where the taxpayer agreed in one year to the essential elements of the proposed sale, but did not consummate the sale until the following year (United States Industrial Alcohol Co.). In both situations, the items accrued in the later period when the taxpayers' obligations became fixed and unconditional.

this occurred _after_ the close of the tax year in issue which ends May 31, 1967, the underlying expense is (at the close of the tax year) a contingent expense for which a deduction cannot be presently allowed. The contingent nature of this liability is plainly shown by the undisputed facts in this case. In the first place, at the close of the tax year in question (May 31, 1967), Atlantic's distributors had no presently exercisable right to return records. The 10-percent return privilege was an exercisable _quarterly_, and the quarter in question did not end until one month _after_ the close of the tax year in issue.[13] Not only were the estimated record returns not permitted before the close of the tax year in issue, but there were several important contingencies which had to occur before Atlantic's liability for credits arose. It was recognized by both witnesses at trial that a distributor could not return records until it received written authorization from Atlantic. (The written authorization would indicate the 10 percent of gross sales figure for the prior quarter which was the maximum returns allowed under the regular return policy. If a distributor was allowed to return more than the 10-percent

13/ Taxpayers' witness (Vogel) testified that returns were permitted on a quarterly basis, and not more frequently for reasons of administrative convenience. (R. 52a.)

figure, presumably this increased amount was stated.[14/]) The record shows (R. 68a) that the authorizations were not issued until two or three weeks after the close of the quarter. More important, however, is the fact that the credits Atlantic is seeking to accrue and deduct are contingent liabilities which Atlantic will not incur unless the distribution in fact returns unsold or damaged records to taxpayer's factory and then only if the records are returned within a reasonable time after taxpayer issues its authorization. While the

14/ Vogel responded (R. 70a) on this point as follows:

> Q. Before the records were shipped by the distributor to the factory, did the distributor have to obtain your permission?
> A. The permission--
> Q. The permission of Atlantic? Pardon me.
> A. Yes, the permission was the return authorization that we sent to him when we first made our computation at the end of the calendar quarter.

With respect to the invoice provision relating to return authorizations, the distributor's employee, Rakliff, testified as follows: (R. 95a)

> Q. It [the invoice] states, final sale, no merchandise returnable without written authorization from this office. What does that mean to you? * * *
> A. Yes, It means that we have to have a written authorization to return any merchandise to them, and there is a 10 percent quarterly return privilege that we are entitled to.
> Q. So that to return any merchandise, including the 10 percent, you had to have written authorization--
> A. Right.

contingencies relating to the close of the calendar quarter and the issuance of a return authorization may be viewed as technicalities, such is not the case with respect to the contingency relating to the actual and prompt return of the unsold records for credit. The actual return of the unsold records was a strict requirement, for while the unsold records may have been destroyed, taxpayer based the reduction in its royalty obligations to artists on the records which were returned to it. (R. 44a-45a, 69a, 119a.) If the distributor failed to return any record or returned them too late, it would receive no credit. (R. 68a.) Plainly, Atlantic's liability for credits for future returns of merchandise is a contingent item, and for this reason under the "all events test" taxpayer cannot accrue the future expense in issue and claim a current deduction.[15/]

15/ In addition, Atlantic has not satisfied the second requirement for the accrual of an item, since it made no effort to estimate with reasonable accuracy the total credits it anticipated allowing (for returns of unsold records) at the close of the calendar quarter involved. The total credits it ultimately would allow would depend, of course, on the total records returned under the regular 10 percent return privilege plus any negotiated returns over and above the 10-percent limit. Atlantic does not estimate the total amount of credits to be allowed under both return programs, but instead claims deductions for those returns subject to the regular 10-percent limit. The fact that within certain limitations Atlantic can estimate a minimum number of record returns does not, of course, change the contingent nature of this item. It also follows that by estimating the minimum number of records to be returned, Atlantic has admittedly failed to determine the total amount of credits for future record returns with reasonable accuracy.

The question whether a taxpayer can estimate its future returns of merchandise and claim a current deduction for such estimated liabilities has been considered in several cases and resolved adversely to the taxpayer. In Readers' Pub. Corp. v. United States, 40 F. 2d 145 (Ct. Cl., 1930), the court considered a publishing company's claimed deduction for estimated returns of unsold magazines. As here, the publisher in that case gave a full credit (plus handling charge) for returns of unsold magazines, which had no value except as waste paper. The court ruled (R. 148) that taxpayer could not claim a deduction until the unsold magazines were actually returned and the credit liability established in the following year. See also J.J. Little and Ives Co. v. Commissioner, supra, in which the Tax Court rejected a similar argument advanced by a book publisher, and Scott Krauss News Agency, Inc. v. Commissioner, supra, where it was conceded that a deduction for estimated returns of unsold magazines could not be allowed.

In accord with these "returns and allowances" cases are those decisions involving taxpayers who sell a product or commodity in the current year for a fixed price, subject to adjustment for weight shortages and quality variations, which are not determined until the following year when delivery occurs. These taxpayers, the courts uniformly rule, cannot estimate the amount of these future adjustments and claim

a current deduction for such an item. See e.g., David J. Joseph Co. v. Commissioner, 136 F. 2d 410 (C.A. 5, 1943) (involving anticipated allowances for weight shortage and quality variations in sales of scap iron); Farmville Oil and Fertilizer Co. v. Commissioner, 78 F. 2d 83 (C.A. 4, 1935) (involving estimated future price adjustments related to currrent sales of fertilizer); and Moore v. Commissioner, 8 B.T.A. 749 (1927) (involving estimated future price adjustments on allowances in connection with current sales of coal.) These representative cases, and many others, have disallowed deductions for such future, contingent expenses.[16]

16/ Another line of cases (see e.g., Shapleigh Hardware Co. v. United States, 81 F. 2d 697 (C.A. 8, 1936)) have considered cash discounts for prompt payment, and ruled that a taxpayer cannot at the close of a tax year estimate and deduct the amount of such cash discounts related to current sales that it will allow at the beginning of the next year. The discount is a contingent liability and a taxpayer must wait until the prompt payment is actually received and the discount earned. In the case at bar, taxpayer gave a two-percent cash discount for prompt payment (R. 84a, 105a, 120a), but recognizing the contingent and therefore nondeductible nature of this item, taxpayer has not attempted to estimate and currently deduct the estimated future liability for such discounts. (Br. 6.) In another line of related cases (See e.g., San Diego Transit-Mixed Concrete Co. v. Commissioner, 2 T.C.M. 743 (1962) relied on by taxpayers (Br. 7), involved trade discounts which are uniformly and unconditionally given certain customers have been treated as reductions in the actual selling price and, to the extent of the discount, not included in income. In the present case Atlantic gave to certain distributors a uniform, across-the-board, three-percent functional discount on all album sales (R. 61a, 67a, 117a.) In the court below the Commissioner conceded (R. 122a) the three-percent discount could be offset from sales since no contingencies were attached by Atlantic to this discount.

The reason, of course, that taxpayers are not permitted to estimate future returns and claim current deductions for the anticipated allowances is that such estimated liabilities constitute what are frequently called "reserves." It is well established that a taxpayer cannot establish a "reserve" for future contingent expenses and deduct currently any increase in that reserve. Obviously, any deduction for such increases for future expenses would violate the "all-events" test, and cannot be permitted without Congressional approval. See Brown v. Helvering, 291 U.S. 193 (1934) where the Supreme Court prohibited a taxpayer, an insurance broker, from estimating and deducting currently the amount of insurance commissions it anticipated it would have to return to its insurance company due to policy cancellations occurring in the subsequent year. See also McAllister v. Commissioner, 417 F. 2d 581 (C.A. 9, 1969), on similar facts, and Readers Pub. Corp. v. United States, supra, involving "reserves" for returns of unsold magazines. In connection with "reserves" which have been authorized by Congress, Section 462 of the Internal Revenue code of 1954 (26 U.S.C.), warrents mention. That provision, which was added to the Code in 1954 and repealed one year later, authorized accrual method taxpayers to claim a deduction for a reasonable reserve for future expenses which would not be otherwise deductible under normal accrual rules. But due to the difficulties of administering such a provision and anticipated revenue losses, the provisions of

Section 462 were repealed in 1955, one year after the Section was inacted. (Act of June 15, 1955, c. 143, 69 Stat. 134, Sec. 1(b)), leaving the deductions for estimated future liabilities, such as these claimed here, subject to the strictures of the "all-events" test. American Automobile Ass'n v. United States, 367 U.S. 687, pp. 694-697 (1961).

Unlike taxpayers (Br. 17) we see no reason to believe that this Court might be confused over the necessary inferences which should be drawn from the repeal of Section 462. Clearly, the liability taxpayer asserts on account of future, estimated returns, constitutes a "reserve" for an anticipated, contingent expense. The fact that this liability is regularly incurred only shows that it is the type of reserve item which Congress dealt with momentarily with the ill-fated provisions of Section 462. Subsequent to the repeal of Section 462, such contingent, future items have been subject to the strictures of the all-events test, as we have noted the Supreme Court has ruled. Unless a special authorization is provided permitting a deduction for reserves (see e.g., Sec. 167 (26 U.S.C.) relating to deductible reserves for bad debts), such expenses are not deductible.

Taxpayer's reliance (Br. 16) on this Court's decision in Central Cuba Sugar Co. v. Commissioner, 198 F. 2d 214 (1952), cert. denied, 344 U.S. 874 (1952), is misplaced. That case involved a broker's commissiner payable on current sales of sugar which were shipped in the subsequent year. The commissions payable were subject to change to reflect adjustments

in the sale price, and no commission would be paid if the buyer failed to perform. The Commissioner argued that the future commission expense was subject to contingencies and should not be deducted currently. This Court disagreed, stating (p. 218):

> * * * it would seem the height of business judgment and tax wisdom to establish a reserve and deduct the expense thus set aside in the year in which the related income accrues.

The main distinction in the facts presented here from these in Central Cuba Sugar Co. is that in Central Cuba Sugar Co. all substantial contingencies had occurred (including the sale and agreement as to price and quantity) in the year in which the commission expense was accrued. Only insubstantial contingencies (weight adjustments) and conditions subsequent (contract nonperformance) remained. Here, on the other hand, the only substantial contingency, i.e., the returns of records, admittedly has not occurred and will not occur until the following year. The existence of this substantial contingency certainly distinguishes this case from Central Cuba Sugar Co.

It should also be noted that Central Cuba Sugar Co. was based on the view that the establishement of "reserves" for future expenses reflected economic realities and resulted in a desirable matching of income and deductions, as the above quotation from the decision points out. Two years after Central Cuba Sugar Co. was decided, Congress concurred in

such a view by adding the provisions of Section 462 of the Code which, as we have noted, were repealed one year later. Since the Supreme Court in American Automobile Ass'n has in effect interpreted this repeal to constitute a prohibition on the use of "reserves" and the deduction of estimated future expenses, and since in so doing the Court rejected the notion that traditional accounting rules can be modified where the taxpayer seeks to match related items of income and deduction,[17/] it would appear that to the extent Central Cuba Sugar Co. relies on the desirability of reserves and the matching of related items of income and deductions, the result reached in that case is of limited continuing precedential value.[18/]

17/ In American Automobile Ass'n (which involved an attempt to defer taxation on prepaid dues) the Court insisted on compliance with traditional tax accounting practices even though, as the Court itself noted (pp. 692, 714), taxpayer's practices more truly reflected income.

18/ In a similar vein to Central Cuba Sugar Co. v. Commissioner, supra, the decision in W.S. Badcock Corp. v. Commissioner, 491 F. 2d 1226 (C.A. 5, 1974), relied on by taxpayer (Br. 16), involved the deductibility of sales commissions and ruled that the normal commercial risks of noncollection did not present a sufficiently substantial contingency to prevent the accrual of the commissions under the all events test. The case is distinguishable for, unlike the case at bar, the most substantial contingency, i.e., sale of merchandise, occurred in the tax year in which the deduction for commissions was claimed. The case of Helvering v. Russian Finance & Construction Corp., 77 F. 2d 324 (C.A. 2, 1939), also relied on by taxpayer (Br. 16), is more supportive of the Government's position, than taxpayers'. In that case, the taxpayer, pursuant to a settlement of a dispute, agreed to pay a stated price per ton for ore exported with a minimum royalty of $1,500,000 per year. The taxpayer paid the minimum royalty and claimed a deduction for it, which this Court permitted, since the item in question was not contingent but, instead, represented an obligation of the taxpayer which was presently enforceable against it. Finally, taxpayers' reliance on

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

SCOTT P. CRAMPTON,
Assistant Attorney General,

GILBERT E. ANDREWS,
JONATHAN S. COHEN,
ARTHUR L. BAILEY,
Attorneys,
Tax Division,
Department of Justice,
Washington, D.C. 20530.

DECEMBER, 1975.

18/ (continued)
Pacific Grape Prod. Co. v. Commissioner, 219 F. 2d 862 (C.A. 9, 1955), is misplaced, for, like Central Cuba Sugar Co., the case (which permitted taxpayer to establish a reserve for future shipping expenses) was decided prior to the repeal of Section 462 (which in fact permitted such a practice) and prior to the Supreme Court decision in American Automobile Ass'n, supra, which, interpreting this repeal, has recognized that only statutorily permitted reserves can be allowed.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing four copies thereof on this 23rd day of December, 1975, in an envelope, with postage prepaid, properly addressed to him as follows:

Alfred D. Youngwood, Esquire
Paul, Weiss, Rifkind, Wharton & Garrison
345 Park Avenue
New York, New York 10022

Gilbert E. Andrews/peak
GILBERT E. ANDREWS,
Attorney.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 61. GROSS INCOME DEFINED.

(a) General Definition.--Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

SEC. 446. GENERAL RULES FOR METHODS OF ACCOUNTING.

(a) General Rule.--Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

* * *

(c) Permissible Methods.--Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting--

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

* * *

SEC. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) General Rule.--The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

* * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§1.461-1 General rule for taxable year of deduction.

(a) General rule--* * *

* * *

(2) Taxpayer using an accrual method. Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. While no accrual shall be made in any case in which all of the events have not occurred which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year of such part thereof as can be computed with reasonable accuracy. For example, A renders services to B during the taxable year for which A claims $10,000. B admits the liability for A for $5,000 but contests the remainder. B may accrue only $5,000 as an expense for the taxable year in which the services were rendered. In the case of certain contested liabilities in respect of which a taxpayer transfers money or other property to provide for the satisfaction of the contested liability, see §1.461-2. Where a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.